9000 TAX CREDITS

Once the proper tax rate is applied to California net income, tax credits are subtracted in determining the proper tax under California law. The rules for determining tax credits are very detailed, and frequently the rules will change from year to year. An in-depth discussion of the specific rules for each credit is beyond the scope of this manual. Instead, this section of the manual is intended only to provide a general overview of many of the available credits. Auditors examining tax credits should always refer to the specific statute for the credit and the year involved.

Reviewed: December 2002

9010 GENERAL INFORMATION

Tax credits must reduce tax in the following order (R&TC §23036(c)):

- Credits, which can not be carried over
- Credits, which can be carried over
- Alternative Minimum Tax credit (see MATM 8580)
- Credits for taxes withheld.

Credits cannot reduce tax below the minimum franchise tax. Additionally, only the credits specifically listed in R&TC §23036(d)(1) may reduce regular tax below the tentative minimum tax, and then only after the alternative minimum tax credit has been allowed. The only credits that are allowed to reduce AMT are carryovers of the solar energy credit provided by R&TC §23601 (repealed effective January 1, 1987) and the commercial solar energy credit provided by R&TC §23601.4 (repealed effective December 1, 1989).

Generally, the amount of credit that exceeds the minimum franchise or the tentative minimum tax may be carried over to offset tax in subsequent years. A credit may be carried over regardless of whether the statute providing for the credit has expired or been repealed.

Unless otherwise specified in the statute, tax credits may be claimed only by the taxpayer incurring the cost (*Appeal of AeroVironment, Inc*., Cal. St. Bd. Of Equal., January 10, 1997 and *Appeal of Guy F. Atkinson Company,* Cal. St. Bd. Of Equal., March 19, 1997)(The California Superior Court has heard the Guy F. Atkinson case and has also ruled in favor of the FTB. The decision is currently being appealed to the next level.). As of January 1, 1992, if two or more taxpayers share in the costs, then each taxpayer may claim the tax credit in proportion to the costs paid or incurred. (R&TC § 23036(g))

Unless specifically stated otherwise (i.e., low-income housing, Enterprise Zone wage and LAMBRA wage credits), corporations that are members of a combined unitary group must compute credits and apply the credit carryovers on a separate basis. The auditor should determine the allowable tax credits of a combined taxpayer through intrastate apportionment. (See MATM 7900 for an explanation of intrastate apportionment.)

SOL Considerations for Credit Carryovers:

By the time that a credit carryover is used, the statute of limitations has often expired for the prior year in which the tax credit was generated. An expired SOL will not bar the auditor from examining the prior year credit in order to determine the affects on the open years. Therefore, if a material credit was not thoroughly reviewed in the year that it was generated, it should be reviewed in the year that the carryover results in a tax effect.

On the other hand, once the SOL has expired for a particular year, income from that year may not be recomputed to reduce the amount of tax credit available to be carried forward. R&TC §19043.5 (effective January 1, 2002) eliminated adjustments to credit carryovers from the definition of "deficiency", thereby, eliminating the need to issue zero-balance NPA's. R&TC §19043.5 provides that instead of issuing zero-balance NPA's, FTB may mail to the taxpayer a notice of proposed carryover adjustmentformerly 25662.1(b)(3)) provides that adjustments to income are deemed to be deficiencies to the extent that they reduce the amount of credit available to be carried forward, even though there may be no tax effect in that year. Those adjustments must therefore be reflected on a zero-balance NPA issued prior to the expiration of the SOL.

Reviewed: December 2002

9020 ALCOHOL FUEL DEVICE CREDIT (R&TC §23603)

For years 1982 through 1990 a credit is allowed for converting a car or truck to use alcohol fuel, consisting at least 85% methanol or ethanol. There is no comparable federal provision. The auto must be registered in California. The credit is equal to 55% of the cost of conversion and is limited to $1,000 per vehicle. The credit cannot reduce tax below the tentative minimum tax. The credit may not be carried over to subsequent years.

Reviewed: December 2002

9030 CHILD CARE CREDIT (R&TC §23617 & R&TC §23617.5)

Since 1988 California has allowed two separate credits for employee child care expenses: the credit for start-up costs and referral service fees and the credit for contributions to a child care plan. Both credits apply to costs incurred on or after September 23, 1988. Both may be carried over indefinitely, but cannot reduce the tax below the tentative minimum tax. There are no comparable federal credits.

Reviewed: December 2002

9032 Start-Up Costs & Referral Service Fees (R&TC §23617)

For years 1988 through 1997, employers may take a credit for establishing a childcare program or facility or contributing to a California childcare information and referral service for the benefit of their employees. In addition, for years beginning after January 1, 1993, owners of commercial buildings may claim a tax credit for the above-mention childcare services that they provide to the employees of the tenants of their buildings. In any event, the facility must be in California and either on-site or near-site.

The credit is equal to 30% of the start-up expenses. The amount of credit, including any carryover amount, claimed against tax in any year cannot exceed $50,000. Legal Ruling 93-2 contains several situational examples that provide clarification of the credit limitation and carryover amounts in each year.

Any business expense deductions for which the taxpayer would otherwise be eligible must be reduced by the amount of the credit. Alternatively, the taxpayer may elect to take depreciation instead of a credit.

Reviewed: September 2003

9034 Contributions To A Child Care Plan (R&TC §23617.5)

For years 1988 through 1997, a credit for contributions, on behalf of employees, to a qualified child care plan for care of the employees' dependents is allowed. However, after 1994 there were several changes to the credit provisions. The auditor should refer to the appropriate version of R&TC §23617.5 when reviewing this credit.

Prior to 1995, the credit is equal to 50% of the contribution, limited to $600 per dependent. After 1994 the credit is calculated at 30% and limited to $360 per dependent. To qualify for the credit in years 1988 through 1994, the dependent must be no more than 15 years old. The age limitation was lowered to 12 years for years after 1994.

Before 1995, a contribution may either be a direct payment to the childcare provider and/or a reimbursement payment to the employee. Legal Ruling 93-1 states employer contributions include amounts designated by an employee in salary reduction agreements, even though the amount is excludable from the employee's taxable income. However, the credit is limited to the amounts contributed to the childcare program. For years after 1994, the contribution must be only a direct payment to the childcare provider.

Other requirements are:

- The facility must be located in California and licensed, if required. The employee's spouse, dependent or children under the age of 19 may not provide childcare.
- No credit is allowed to the extent that the sum of the employer's contributions plus the employee paid fees exceed the total cost of providing care.
- If the contributions are used at a facility owned by the employer, the basis of the facility must be reduced by the amount of the credit.
- A business expense deduction is not allowed for the amount of the credit.
- If two or more taxpayers share the costs eligible for the credit, each taxpayer is eligible to receive a tax credit with respect to its respective share of the costs paid or incurred (R&TC §23617(d)).

Reviewed: December 2002

9040 CLINICAL TESTING (ORPHAN DRUG) CREDIT (R&TC §23609.5)

For years 1987 through 1992 California allows a credit for the cost of clinical testing and development of (orphan) drugs for rare diseases. California basically conforms to IRC §28, with the following exceptions:

- The clinical testing must be performed in California
- California allows a credit of 15% of the clinical testing expenses; federal law allows 50%.
- Carryover of the credit is allowed for California purposes

Deductions for corresponding expenses must be reduced by the amount of the credit claimed. (R&TC §24440.)

The credit is allowed to reduce tax below the tentative minimum tax.

Reviewed: September 2003

9050 DONATED AGRICULTURAL PRODUCTS CREDIT (R&TC §23608)

For years 1989 through 1991 a credit is allowed for agricultural products, which are donated to nonprofit organizations. The credit is equal to 10% of inventory costs, defined under IRC §263A and includes farming operations.

The nonprofit organization is required to provide the taxpayer a certificate containing the donor's name, the type and quantity of product donated and the donee's name and address. The auditor should request this certificate when examining the credit.

The taxpayer must reduce any deduction that would otherwise be allowed by the amount of the credit claimed. Since there is no comparable federal credit, a state adjustment may be required. (See MATM 6055.)

The credit may not reduce tax below the tentative minimum tax, but may be carried forward until exhausted.

Reviewed: December 2002

9060 ENTERPRISE ZONE AND PROGRAM AREAS CREDITS

Since 1984 specific Wage and Sales & Use tax credit provisions have been enacted to stimulate development and employment in selected areas in California. Enterprises Zones (zones) are economically depressed areas. Program Areas (areas) are locations with high levels of unemployment.

The credits may only be claimed for operations after the zone or area has received final approval. Locations have been designated as zones and areas on different dates throughout the years; therefore the auditor should verify the date of designation.

The credits are limited to the tax on taxpayer's business income attributable to the business operations located within the zone or area. If the business is located both within and outside of, or in more than one incentive area, the taxpayer must determine the portion of income or loss of its business operations attributable to the enterprise zone or program area. For taxable years beginning before January 1, 1991, this income is determined by multiplying the worldwide business income by the standard three-factor formula. For taxable years beginning on or after January 1, 1991 through taxable years ending on or before December 31,1996 a two-factor formula of payroll and property is applied. For taxable years beginning on or after February 1, 1996, (1996 fiscal year taxpayers, 1997 calendar year taxpayers) business income of the incentive area will be apportioned by use of the four-factor apportionment formula. For taxable years beginning on or after January 1, 1998, business income is apportioned to the zone by multiplying the taxpayer's total California source business income by a two-factor formula of property and payroll. For corporations filing a combined report, the taxpayer's California source business income is the intrastated California business income of the corporation operating within the zone. Both credits can reduce tax below the tentative minimum tax for years 1993 and after. The unused amounts may be carried over to future years.

Program areas and enterprise zone statutes were repealed, effective the close of the applicable 1996 year end. Previous program areas and enterprise zones were then reenacted as enterprise zones effective for taxable years beginning on or after January 1, 1997. R&TC statutes were renumbered and partially changed. All carryover amounts from program areas and enterprise zone incentives are allowed to be carried over under the new enterprise zone provisions.

A listing of the zones or areas and respective approval dates can be found in FTB Publications 1047 (Enterprise Zones), 1158 (for taxable years beginning on or after January 1, 2001) or 1048 (Program Areas – expired for taxable years beginning on or after January 1, 1997) or Form FTB 3805Z. On October 14, 2001, a portion of the Mid-Alameda Corridor enterprise zone, City of Lynwood, expired. All other enterprise zones, or portions thereof received approval for a five-year extension period.

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Reviewed: January 2004

9062 Hiring Credit

(R&TC §23622 And R&TC §23623 – Both §'S Repealed For Taxable years Beginning On Or After January 1, 1997)(R&TC §23622.7 Enacted For Taxable years Beginning On Or After January 1, 1997)

Businesses operating in either a zone or area may claim a credit for a portion of the wages paid to qualified disadvantaged individuals. The credit provisions (i.e., qualified individuals) differ depending on whether the business is in a zone or area. Furthermore, for years after 1994, the definition of "qualified disadvantaged individual" for an Enterprise Zone credit was broadened. Prior to 1995 individuals are required to be in a state or federal jobs program. Beginning in 1995, individuals must only be eligible for the programs. The auditor should refer to the appropriate code sections when reviewing this credit.

To determine if a specific employee qualifies the taxpayer for the credit, the auditor should obtain the information listed below on each employee.

- Unemployment history, if a program area
- Address of employee, if a program area
- Date of employment
- Amount of wages paid
- Description of duties performed
- Location of employment
- Voucher

For enterprise zones, a qualified employer is one that has obtained and retained a voucher to certify that their employee meets any one of the qualifying criteria. Failure to obtain the voucher results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit.

Generally, the amount of the credit is 50% of qualified wages in the first year after commencement of the employment, 40% in the second year, 30% in the third year, 20% in the fourth year, and 10% in the fifth year. The percentage is applied to the lesser of the actual hourly wage or 150% of the minimum hourly wage. For example in 1994, the maximum wage the credit could be based on is $6.37 (150% of $4.25).

The amount of either credit must be reduced by the Jobs Credit (R&TC §23621) or the federal Target Jobs credit (through 1995) (IRC §51) or the Work Opportunity Credit (beginning in 1997) (IRC §51). The business expense deduction for wages under R&TC §24343 (IRC §162) must be reduced by the amount of the credit allowed. A state adjustment will result since there is not a comparable federal credit. (See MATM 6057)

If an employer terminates an employee within 270 days of employment, credits previously claimed will be recaptured as additional tax in the year of termination. There are several termination exceptions, therefore, the auditor should consult the statute when examining this issue.

The Program Area and Enterprise Zone credits may be carried over until exhausted

Regarding the Enterprise Zone Hiring Credit: All employees of corporations that are members of the same controlled group are considered employed by a single employer. As such, the credit allowed to each member is determined by its proportionate share of qualified wages. (R&TC §23622(e); R&TC §23622(f) after 1994)

Reviewed: December 2002

9064 Sales & Use Tax Credit

(R&TC §23612 – Repealed For Taxable years Beginning On Or After January 1, 1997)(R&TC §23612.2 – Enacted For Taxable years Beginning On Or After January 1, 1997)

The amount of sales or use tax paid on the purchase of qualified machinery or parts used in an Enterprise Zone or Program Area may be allowed as a credit against tax. The machinery must be used only within the designated zone or area. The credit is allowed for the tax paid on the first $20 million of the machinery cost. The auditor should verify the type of property purchased, the amount of sale or use tax paid, and the location where the property was used.

The credit is only allowed on out-of-state purchases when machinery of a comparable quality and price was not available in California. The auditor should have the taxpayer substantiate that attempts were made to purchase comparable machinery in California.

If the credit is claimed, the sales or use tax paid may not be included in the basis of the machinery. Unused credit may be carried over until exhausted.

Reviewed: December 2002

9070 JOBS TAX CREDIT (R&TC §23621)

Since 1979, California law has allowed a credit for wages paid to employees in specified disadvantaged and disabled categories. R&TC §23621 is generally similar to IRC §51 with the following exceptions:

California's credit amount is equal to 10% of qualifying wages in the first two years of employment. The federal credit is 40% of the first years wages. There is no federal credit in the second year.
California limits the credit to $600 per employee and total qualifying wages of $3,000 per year. The aggregate federal limit is $6,000.
California has a narrower list of categories of qualified employees.
The California credit cannot be claimed if the employee begins work after December 31, 1993. For federal purposes the credit expires December 31, 1994.
The California credit is in addition to other deductions to which the taxpayer is entitled. However, an employer who claims this credit cannot also claim an Enterprise Zone, Program Area or Los Angeles Revitalization Zone credit for the same wages. (See MATM 9062, MATM 9092 & MATM 9094.)

The employer must have received certification from the Employment Development Department (EDD) or made a written request to the EDD for certification prior to the date the employee begins work. The auditor should request the certification and verify the dates. The credit is not allowed for wages paid prior to the contact with EDD or if the certification is revoked.

The credit does not apply to wages paid to any employee who is a dependent of the corporation's 50% or more owner. Also, the credit may not be claimed for payments made for services provided during labor disputes. The credit may not reduce tax below the tentative minimum tax. There is no provision in the statute for a carryover of this credit.

Reviewed: December 2002

9080 LOCAL MILITARY AGENCY BASE RECOVERY CREDIT

In an effort to encourage employment in certain military base areas, specific locations have been designated as Local Agency Military Base Recovery Areas (LAMBRA). Two credits (Sales or Use Tax Credit and Hiring Credit) have been established for LAMBRA businesses.

To qualify for either credit the LAMBRA business must have a net increase of one employee in a LAMBRA during the first two years. At the end of the second year, if the number of employees has not increased, the credit previously claimed will be added to the second year's tax.

The amount of either credit (or both, if applicable) may not exceed the amount of tax on the enterprise zone or program area business income in any year. If the taxpayer qualifies for any other type of Sales or Use Tax Credit or Hiring Credit due to the business overlapping with another designated zone (i.e. Targeted Tax Area and LAMBRA), the taxpayer may claim only one Sales or Use Tax Credit and one Hiring Credit.

The LAMBRA credits cannot reduce tax below the tentative minimum tax.

For further details regarding economic development area tax incentives, refer to the Economic Development Areas Audit Manual.

Reviewed: December 2002

9082 Sales And Use Tax (R&TC §23645)

A sales or use tax credit is allowed for LAMBRA businesses that purchase qualified property to be used in LAMBRA. This credit is similar to the provisions of R&TC §23612.2 - Sales Tax Credit on Qualified Property for Use in Enterprise Zones and Program Areas (See MATM 9064).

Qualified property includes high technology equipment, aircraft maintenance equipment, aircraft components and IRC §1245 property. R&TC §23645 contains several examples of the type of property that is included in these categories.

Property must be *manufactured* in California, unless property of a comparable quality and price was not available from a California manufacture. The auditor should have the taxpayer substantiate that attempts were made to purchase California manufactured property.

If within two years of its purchase the property is disposed of by the LAMBRA business or is no longer used within the LAMBRA, the credit amount will be added to the tax liability in the year of nonuse or disposition.

Reviewed: December 2002

9084 Hiring Credit (R&TC §23646)

A LAMBRA business may qualify to claim a credit for a portion of the wages paid to qualified disadvantaged individuals and displaced military base employees. Generally, this credit parallels the Enterprise Zone Wage Credit allowed under R&TC §23622 (R&TC §23622.7 for taxable years beginning on or after January 1, 1997). However, the LAMBRA qualified employee requirements are much broader than those under the Enterprise Zone credit provisions. Furthermore, the wage amount used to compute the LAMBRA credit is limited to $2 million in each year. The auditor should be familiar with the provisions of R&TC §23646 when reviewing the LAMBRA credit.

Reviewed: December 2002

9090 LOS ANGELES REVITALIZATION ZONE CREDIT

For taxable years beginning after 1991 and before 1998, three tax credits were enacted to aid the economic growth, create jobs and encourage rebuilding of businesses in the part of Los Angeles County that suffered physical and economic damage from civil disturbances in April and May 1992. The three credits are the Hiring Credit for Construction Workers, the Hiring Credit for Employees Other than Construction Workers, and the Sales and Use Tax Credit.

Information regarding the boundaries of the LARZ can be found in FTB Publication 1044. Further assistance with these credits can be found in FTB Booklet 3806, from the Enterprise Zone Specialist at [(916) 845-3464], and in the Economic Development Areas Audit Manual.

All three credits are similar to the Hiring and Sales or Use Tax Credits allowed for Enterprise Zone employers. (See MATM 9060) For instance:

1. The wage credits must be reduced by credits claimed for other state and federal job or wage tax credits. Likewise, any wage or salary business deduction must be reduced by the amount of the credit.
2. The credits must not exceed the amount of tax on the income attributable to the business activities within the LARZ. A two-factor apportionment formula of property and payroll is used to determine income attributable to LARZ business activity. For 1992 and 1993, unitary business income is apportioned to the LARZ by multiplying the worldwide business income by the ratio of the LARZ taxpayer's property and payroll occurring in the LARZ, over the group's property and payroll worldwide. For 1994 and later, business income shall be apportioned to the LARZ by multiplying the taxpayer's California source business income by the same two-factor formula of property and payroll except that the denominator will be the separate property and payroll of the LARZ taxpayer in the state of California. For corporations filing a combined return, the California source business income will be the intrastated California business income of the corporation operating within the LARZ.
3. The credits may be carried forward for the longer of the life of the LARZ or 15 years.

Reviewed: December 2002

9092 Wages Paid To Construction Employees (R&TC §23625)

A credit is allowed for a specified amount of wages paid by an employer in hiring a construction worker who is a **resident** of the LARZ. The employee must perform **construction** work in the LARZ. The amount of the credit is based on the date the employee was hired and is limited to wages paid during that period:

Date Hired	Credit Percentage	For Wages Paid Between
5/1/92 - 6/30/93	100%	5/1/92 – 6/30/93
7/1/93 - 12/31/93	75%	7/1/93 – 12/31/93
1/1/94 - 12/31/97	50%	1/1/94 – 12/31/97

No credit is allowed if the employee is hired before May 1, 1992 or after December 31, 1997, the date R&TC §23625 is repealed.

For years 1993 and after, this credit can reduce tax below the tentative minimum tax.

The remaining provisions are similar to the Enterprise Zone Wage Credit under R&TC §23622 (R&TC §23622.7 for taxable years beginning on or after January 1, 1997). (See MATM 9062.)

Reviewed: December 2002

9094 Wages Paid To Qualified Disadvantaged Employees (R&TC §23623.5)

LARZ employers are also allowed a credit for hiring qualified disadvantaged individuals. This credit is substantially similar to the Enterprise Zone Employer's Credit (MATM 9062), except that the qualified employees must be *residents of the LARZ and hired on or after May 1, 1992*.
This credit may not reduce tax below the tentative minimum tax in years 1992 or 1993. The tentative minimum tax can be reduced by this credit for years beginning on or after January 1, 1994.

Reviewed: December 2002

9096 Sales & Use Tax (R&TC §23612.6)

A LARZ business may claim a credit for the amount of sales or use tax paid on the purchase of building materials to replace or repair the taxpayer's building and fixtures, and machinery or equipment to be used within the LARZ. The property must be purchased on or after May 1, 1992. There is no limitation on the amount of property purchased.

If another credit is available for such property, the taxpayer is allowed only one credit.

The basis of the property may not be increased by the amount of credit claimed.

If the property is disposed of or is no longer used by the taxpayer within the zone before the close of the second taxable year after the property is placed in service, the amount of the credit will be added to the tax liability in the year of non-use or disposition.

For years 1993 and later, the credit may reduce tax below the tentative minimum tax.

Reviewed: December 2002

9100 LOW EMISSION VEHICLE CREDIT (R&TC §23603)

In 1991 the Low Emission Vehicle Credit was enacted with the intent of reducing air pollution by encouraging the use of low emission vehicles. The credit is equal to 55% of the differential cost of low emission vehicles or costs of conversion devices, limited to $1,000 per vehicle (or $3500 if the vehicle weighed over 5,750 pounds). Federal law does not contain a comparable credit.

The taxpayer must obtain a certification from the State Energy Resources Conservation and Development Commission (CEC) before qualifying for the credit. If the credit is material, the auditor should request a copy of the CEC's certification from the taxpayer for each low emission vehicle purchased or converted.

The credit is allowable in years 1991 through 1995. It may not reduce tax below the tentative minimum tax. However, this credit can be carried over until exhausted.

Reviewed: December 2002

9110 LOW-INCOME HOUSING CREDIT (R&TC §23610.5)

After 1986, California allows a credit to taxpayers who invest in low-income housing projects. The credit is computed in accordance with the federal credit under IRC §42. This discussion covers the areas where California law differs from federal. Whether or not the IRS has examined the federal credit, the auditor should examine these areas.

The low-income housing project must be located in California. The credit must be allocated and authorized by the California Tax Credit Allocation Committee (CTCAC). In addition, the CTCAC must have authorized a federal credit to the taxpayer or the taxpayer must qualify for the credit under IRC §42(h)(4)(B).)

A copy of the CTCAC certification must be attached to any return in which the credit is claimed. The auditor should review the return for the certification. If the certification is not attached and the taxpayer cannot provide a certification, the credit may be disallowed.

California allows the credit to be claimed over a four-year period, not ten years as required under federal law. The applicable percentage of cost for computing the credit has changed over the years. In addition, the applicable percentage may depend on the highest federal rate and if the project is federally subsidized. The auditor should refer to R&TC §23610.5 and IRC §42 when verifying the credit computation.

An additional credit may be claimed if the basis of a low-income housing building has increased since the CTCAC allocated the original credit. The CTCAC must authorize the additional credit.

California does not conform to the federal provision that allows the owner of a low-income housing unit occupied entirely by full-time students to qualify for the credit

There is no California provision similar to the federal provision that allows an election to claim 150% of the credit in the first year ending after October 24, 1990.

California requires a 30-year "compliance period", whereas the federal law only requires 15 years. The California law contains no provision, similar to the federal provision, for recapture of the credit if a project owner fails to comply with restrictions during the compliance period.

Unlike most credits, which may only be claimed by the entity incurring the costs, any portion of this credit may be assigned to one or more affiliates by election of the taxpayer. However, the affiliate must be 100% commonly owned. Once the election is made it is irrevocable for the year the credit is claimed, but the election may be changed in subsequent years. This credit assignment provision is effective for taxable years beginning on or after January 1, 1993. (R&TC §23610.5(q); formerly (r).)

The credit may reduce tax below the tentative minimum tax and may be carried forward until exhausted. The California credit remains in effect as long as the federal credit does. In 1993, the federal credit was extended indefinitely.

Reviewed: December 2002

9120 MANUFACTURERS' INVESTMENT CREDIT (R&TC §23649)

To stimulate employment in California, the State Legislature enacted three provisions to alleviate the basic sales tax for manufacturing companies on purchases of manufacturing equipment. The Sales and Use Tax Code §6377 provides a partial sales tax exemption for new manufacturing companies equal to 5% of the 6% basic sales tax. As an alternative to the partial sales or use tax exemption, qualified taxpayers may claim a credit against tax on the California income or franchise tax return under R&TC §23649. Or, in lieu of claiming the sales tax exemption or the income of franchise tax credit, Sales & Use Tax Code §6902.2 allows taxpayers to file a claim for refund with the Board of Equalization for the sales and use tax paid. The refund is an amount equal to the income or franchise tax credit that would have been allowed to offset the current year tax liability. The refund may be claimed on or after the date the taxpayer would have been able to claim the credit on the income or franchise tax return.

Generally, a “qualified taxpayer” is allowed a manufacturers’ investment credit (MIC) equal to 6% of the “qualified costs” paid or incurred for “qualified property” that is placed in service in California. Qualified taxpayer, qualified costs and qualified property are the three requirements for claiming the MIC. All three must be met for the taxpayer to claim the credit. Each of the MIC qualification requirements is discussed below.

A "qualified taxpayer" for purposes of the MIC is any taxpayer that is engaged in an activity described in Division D (Manufacturing) of the Standard Industrial Classification (SIC) Manual, 1987 edition (SIC Code 2011- SIC Code 3999). A taxpayer with multiple business activities that are treated as "establishments" under the SIC Manual will be a qualified taxpayer if any one of its activities falls within SIC Code 2011- SIC Code 3999. In addition, for taxable years beginning on or after January 1, 1998, the definition of “qualified taxpayer” is expanded to include any taxpayer engaged in activities related to computer programming services or computer software design, SIC Code 7371 - SIC Code 7373.

The FTB Form 3535 instructions (included in the California Package X) contain a condensed listing of manufacturing activities, which are classified under SIC Code 2011- SIC Code 3999. The SIC Manual describes and uses “establishments” to classify business activities into the various SIC codes. Examples of whether an activity constitutes an “establishment” can be found in CCR §23649-3. See the SIC Manual for a complete listing and the rules for determining classification of the SIC codes. The SIC Manual is available at http://www.osha.gov/cgi-bin/sic/sicser5.

Note: AB 1040 (Ch. 605, Stats 1997) included language stating the legislature’s intent to replace the references in §23649 from the SIC Manual to the new North American Industry Classification System (NAICS) Manual. The NAICS is being used for the Principal Business Activity Code Chart found in the California and federal tax booklets. This system replaces the use of the SIC for purposes of business classification. However, until R&TC §23649 is amended, the SIC Manual will continue to be used for purposes of the MIC.

"Qualified property" refers to new or used IRC §1245(a) tangible personal property or off-the-shelf computer software upon which sales or use tax has been paid. Tangible personal property eligible for the MIC is generally considered to mean any tangible property except land and improvements, such as buildings, other inherently permanent structures, and their structural components. The determination of whether property is considered an inherently permanent structure is made in accordance with the provisions of IRC §1245(a), which describe an "inherently permanent structure" as one, which is affixed permanently and is incapable of being moved without significant damage. Because only tangible personal property qualifies for the credit, CCR §23649-5(b)(2) interprets the IRC §1245(a) requirement to mean that only property described in IRC §1245(a)(3)(A) qualifies for the MIC. One exception to the regulation's general application of the statutory IRC §1245(a) tangible personal property requirement applies to taxpayers engaged in a line of business classified under SIC Code 2911, Petroleum Refining. For this SIC code, qualified property also includes other tangible property that is defined in IRC §1245(a)(3)(B), such as outdoor permanent industrial structures. This property must be primarily used in petroleum refining for the production of "reformulated gasoline" or "oxygenated gasoline."

Another exception to the general IRC §1245(a) tangible personal property requirement is for special purpose buildings and foundations. Even though they are not IRC §1245(a) tangible personal property, special purpose buildings and foundations may also be considered qualified property, but only for taxpayers that are engaged in manufacturing activities that fall within certain SIC codes (generally related to computer or office equipment; electronic components; biotech or biopharmaceutical activities; space satellites and communications satellites and equipment; or semiconductor equipment). Rules regarding this exception are discussed in R&TC §23649(d)(3) and CCR §23649-5(c).

Specifically excluded from the definition of qualified property is furniture, equipment used for warehousing or extraction purposes, inventory, or property used in administration, general management or marketing.

To be qualified property, at least 50% of the property's use must be in an activity that involves manufacturing, processing, refining, fabricating, recycling, research and development, or pollution control; or the maintenance, repairing, measuring or testing of any other qualified property. The business activity must fall within SIC Codes 2011-3999. Definitions of qualified activities are in CCR §23649-2. Also, examples of when property is treated as being primarily used in a qualified activity are in CCR §23649-5. For guidance on determining whether cement mixers for ready-mixed concrete are qualified property, see Legal Ruling 2001-4.

For taxable years beginning on or after January 1, 1998, qualified property also includes property consisting of computers and computer peripheral equipment (as defined in IRC §168(i)(2)(B)) used primarily by a qualified taxpayer to develop or manufacture prepackaged software or custom software. Qualified property for taxpayers involved in computer businesses described in SIC Codes 7371 - 7373 does not include any IRC §1245(a)(3)(A) tangible personal property other than computers and computer peripheral equipment (e.g., shrink-wrap machines, fork lifts, etc.). (R&TC § 23649(d)(2) as amended by AB 2798, Ch. 323, Stats. 1998.)

In general, the term "qualified costs" includes any capitalized costs paid or incurred by a qualified taxpayer for the construction, reconstruction or acquisition of qualified property on or after January 1, 1994. The costs must be properly includable in the taxpayer's depreciable basis of the property. Except for capitalized labor costs, qualified costs are an amount upon which California sales and use tax has been paid (directly or indirectly). For guidance on the use of California State Board of Equalization (SBE) sales and use tax audit results, see FTB Notice 2001-6. Examples of these requirements are in CCR §23649-4(a) - (c).

Capitalized labor costs for the construction or modification of qualified property may also qualify for the MIC, provided they meet the definition of “direct” labor costs under the federal uniform capitalization (UNICAP) rules. The UNICAP rules are in IRC §263A and the regulations thereunder. Examples of the capitalized labor cost requirements are in CCR §23649-4(d).

Note: For more guidance on the treatment of capitalized labor, see FTB Notice 2002-1, MIC Alternative Computation of Capitalized Direct Labor Costs Under Third-Party Contracts, Legal Ruling 2000-1, MIC Capitalized Costs Under Third-Party Contracts, and Legal Ruling 98-1, MIC Capitalized Costs of Labor For Engineering and Design.

A qualified taxpayer who leases qualified property may claim the MIC so long as the lessor paid California sales or use tax when it acquired the property. The lessor may not claim the MIC. The normal "qualified cost" rules do not apply to lessees. Instead, under an operating (or true) lease, the lessee may generally claim the MIC based upon the purchase price amount on which the lessor paid sales or use tax, plus any capitalized labor costs related to the lessor's construction or modification of the property. If the property is later re-leased to another lessee, the second lessee's qualified costs must be reduced by the costs used to compute the prior lessee's MIC. The general requirement that qualified costs must be chargeable to the qualified taxpayer’s capital account does not apply to a lessee’s rental payments under an operating (or true) lease arrangement.

In the case of an operating (or true) lease, the lessor must provide the lessee with a written statement within 45 days after the close of the lessee’s taxable year, containing the amount of the lessor’s qualified costs (i.e., the amount of such cost upon which the lessor has paid California sales or use tax).

If the lease is a finance (or capital) lease for sales and use tax purposes, then the rules applicable to an acquisition will generally apply in calculating the qualified costs of the lessee. These general rules are subject to a few exceptions and refinements depending upon the type of lease and how the transaction is structured. For more information regarding leased property, see R&TC §23649(f) and CCR §23649-6.

The MIC is claimed on FTB Form 3535, Manufacturers' Investment Credit. The taxpayer is required to complete and attach this form to the return. The FTB Form 3535 contains information such as the description of the property, the qualifying activity, the primary use SIC code, whether or not the property is leased, the date placed in service, the sales or use tax paid, the property cost, any included capitalized direct labor costs, etc.

The first year the MIC may be taken is the qualified taxpayer's first taxable year beginning on or after January 1, 1995. In addition to costs actually paid or incurred during that first taxable year beginning on or after January 1, 1995, qualified costs paid or incurred on or after January 1, 1994, may also be claimed in that first credit year. For example, assume a taxpayer with a June 30 year-end. The first taxable year this taxpayer can claim the MIC is its year ended June 30, 1996, the first year beginning after January 1, 1995. To determine its credit, the taxpayer may include all qualified costs incurred from January 1, 1994, through June 30, 1996. For qualified taxpayers engaged in those lines of business under SIC Codes 7371 - 7373, substitute "the first taxable year beginning on or after January 1, 1998," for "January 1, 1994." Rules with respect to costs incurred pursuant to binding contracts in existence prior to January 1, 1994, are covered in CCR §23649-4(e).

The total cost of property eligible for the credit must be reduced by the amount of sales or use tax paid on the property. However, unlike many credits, the basis of qualified property for which the MIC is claimed is not required to be reduced by the amount of the credit.

There is no annual limit on the MIC. However, the amount of the credit that a taxpayer can use may be limited. The credit may not reduce the minimum franchise tax imposed on corporations and certain other entities. The MIC may not reduce the built-in gains tax or the excess net passive income tax imposed on some S corporations; or the limited liability company (LLC) gross receipts fee. Also, the credit may not reduce alternative minimum tax, but may reduce the "regular" California tax below the tentative minimum tax. If a taxpayer takes a Los Angeles Revitalization Zone Credit (R&TC §23612.6) with respect to the same qualified property, the taxpayer cannot take the MIC for that same item.

Generally, the credit can be carried forward for eight years. Small businesses, defined in R&TC §23649(e)(10), can carry the credit forward for ten years. The length of the credit carryover period for a credit generated by a pass-through entity (S corporation, partnership, LLC taxed as a partnership, etc.) is determined at the entity level. For more information regarding the MIC carryforward provisions, see CCR §23649-9.

If the property upon which the credit is claimed is disposed of within one year or less from the date the property was first placed in service in California, the credit must be recaptured pursuant to R&TC §23649(g). Disposition includes removal of the property from California, use of the property primarily in a nonqualified activity, and transfer or sale of the property to an unrelated party, defined by IRC §267, IRC §318 or IRC §707. For more information regarding the recapture provisions, see CCR §23649-8.

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Reviewed: September 2003

9130 RECYCLING EQUIPMENT CREDIT (R&TC §23612.5)

A credit is allowed for those taxpayers that purchase and use equipment to manufacture finished products out of waste materials. The credit is allowed for equipment purchased and placed in service in 1989 through 1993. The credit is equal to 40% of the equipment's cost. The total credit is limited to $625,000 per facility.

The taxpayer must receive a certification from the California Integrated Waste Management Board that the equipment purchase and use is qualified. Property previously certified will not qualify a second time. The auditor should request a copy of the certification. The statute specifically states that if the certification is not provided to FTB the credit may be disallowed.

The basis of the recycling equipment must be reduced by the amount of credit allowed.

This credit may be carried forward until exhausted. However, the credit may not reduce tax below the tentative minimum tax.

Reviewed: December 2002

9140 RESEARCH EXPENSES CREDIT (R&TC §23609)

IRC §41 provides for a federal research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year, or for basic research payments. California allows a similar credit against tax for the amounts paid or incurred for research conducted in California. Generally, the credit is allowed in accordance with IRC §41, modified for California by R&TC §23609. There are several other federal and state differences, as well as several law changes that have been made periodically. Therefore, the auditor should be familiar with the California provisions for the year under audit. The research credit for both existing companies and "start-up" companies is claimed on FTB Form 3523.

California's credit for increasing research activities came into existence under R&TC §23609 for corporations in 1988. Taxpayer's may claim the credit for fiscal years beginning in 1987, but only for qualified research expenses paid or incurred on or after January 1, 1988.

For taxable years beginning on or after January 1, 2000, the California credit is 15% of the excess of qualified research expenses for the taxable year over the base period research expense amount, plus 24% of the basic research payments for corporations. The California research credit rates have changed frequently in recent years. See the table below for rates for the year(s) you are auditing.

Corporations may elect to reduce the regular credit to avoid having to make a state adjustment to income for the amount of the credit. According to IRC §280C(c) & R&TC §24440, deductions claimed for research activities must be reduced by the amount of the current year's research credit. However, if the taxpayer makes a timely election, by the due date for filing the return including extensions, to take the reduced credit, then the state adjustment to income is not required. If the taxpayer does not elect the reduced credit, they must add-back the amount of the credit created for the year, regardless of how much of it is actually used to reduce the current year tax liability. Be aware that taxpayers may have a different election for state and federal purposes and they can change the election from year to year, but the election is irrevocable. If the taxpayer does not elect the reduced credit for federal purposes, there should also be a state adjustment to eliminate the IRC §280C(c) add-back.

For taxable years beginning on or after January 1, 1997, corporations may elect to use the "Alternative Incremental Credit" rather than the regular credit. The alternative incremental credit allows a smaller 3-tiered fixed-base percentage and a reduced 3-tiered credit rate. To use the alternative incremental credit, the taxpayer must make an election for any taxable year beginning on or after January 1, 1997 and cannot change to the regular method unless they receive consent from FTB to revoke the election.

If a material credit is being claimed, the auditor should, at the very minimum, determine if the research is conducted in California and verify that the computation is mathematically correct.

Auditors should ensure that California sales and expenses were used in the computation of the base period percentage. If the IRS is auditing or has audited the same expenses, our audit activity should be limited to verifying that the expenses were incurred in California.

California did not conform to the federal fixed-base period computation until January 1, 1993. For years prior to 1993, California used a three-year moving average to compute the base amount. If needed, refer to the prior law and forms for those years.

This table shows the recent changes in research credit rates:

TAX YEARS BEGINNING	QUALIFIED RESEARCH	BASIC RESEARCH	ALTERNATIVE INCREMENTAL
1987-1996	8%	12%	N/A
1997	11%	24%	1.65%, 2.20%, 2.75%
1998	11%	24%	1.32%, 1.76%, 2.20%
1999	12%	24%	1.32%, 1.76%, 2.20%
2000 and later	15%	24%	1.49%, 1.98%, 2.48%

QUALIFIED RESEARCH EXPENSES:

A review of the costs included in the qualified research expense should be considered. The taxpayer must have incurred the costs while conducting research in California for a qualified activity. Qualified research expense equals the sum of in-house research expenses and contract research expenses (IRC §41(b)(1)). In-house research expenses include compensation, supplies, and amounts paid to another person for the right to use computers in the conduct of qualified research.

IN-HOUSE RESEARCH EXPENSES –

COMPENSATION
For purposes of computing this credit, compensation must be directly related to the research activities and paid by the taxpayer (IRC §41(b)(2)). This may include direct supervision, direct support or direct performance of qualified research. An allocation of the purchasing or receiving departments' wages does not qualify because they are indirect costs. Items, which are considered compensation for purposes of determining the credit, include, but are not limited to, salaries, wages and taxable income from non-qualifying stock plans or disqualifying dispositions of incentive stock options (see *Apple Computer v. IRS*, 98 TC 232; and *Sun Microsystems, Inc., et al.,* TC Memo 1995-69, 69 CCH TCM 1884). Deferred compensation and fringe benefits (such as health benefits) are not qualifying

expenditures. Information to make the above determinations may be found in employees' W-2 records, job descriptions, duty statements, employee evaluations etc.

SUPPLIES
Supplies include all tangible property that is consumed directly by the research activity or that goes into the prototype. The supplies must be used in conducting qualified research. Supplies mean any tangible property, other than land or improvements to land, and property of a character subject to the allowance for depreciation (IRC §41(b)(2)). In some cases, the costs attributable to the construction of molds and other special tooling may not be deductible as research and experimental expenditures under IRC §174 because the costs are for the component material and labor associated with the manufacturing of products sold by the taxpayer to its customers.

Examples of supplies that qualify are those used by a laboratory scientist in experimentation, those used by a laboratory assistant in entering research data into a computer, and those used by a machinist in the fabrication of a part for an experimental model. (See Treas. Regulation 1.41 for more examples.)
Generally, utilities (phone and electricity), small tools, and allocations of the total shipping cost are not qualifying supply expenses. Contract expenses in the cost of supplies are not permissible qualifying supply expenses.

CONTRACT RESEARCH EXPENSES:

Contract research means 65% of amounts paid to any person (excluding taxpayer's employees) to perform qualified research (IRC §41(b)(3)) (For taxable years beginning on or after January 1, 1997, 75% of amounts paid to a qualified research consortium qualify). The outside consultant must perform the research in California. The auditor may review the taxpayer's vendor files and vendor contracts to determine if the expense qualifies.

QUALIFIED RESEARCH DEFINED:

Under IRC §41(d)(1) the following four tests must be met for R&D expenditures to be considered qualified research expenses:

- The expenditures must qualify for a deduction under IRC §174,
- The expenditures must have been made to discover information that is technological in nature,
- The purpose of the research is intended to be useful in the development of a new or improved business component of the taxpayer, and
- Substantially all of the activities constitute elements of a process of experimentation that relates to a new or improved function, performance, or reliability or quality.

INTERNAL-USE SOFTWARE

Software prepared by the taxpayer for its own internal use qualifies for the credit if it is used in an activity which constitutes qualified research or is used in a production process developed through activities constituting qualified research (IRC §41(d)(4)). Other software created for internal use is not eligible for the credit unless it meets the four tests for qualified research (outlined above) plus the following three tests:

- The software must be innovative,
- Its development must involve significant economic risk, and
- It cannot be commercially available for use by the taxpayer.

There are two significant federal court cases concerning qualified activities with regard to internally developed software that the auditors should be aware of:

- *United Stationers, Inc. v. U.S.*, 82 AFTR 2d 98-7488, 12/24/1998 - Credit was disallowed based on lack of technological nature and no experimentation process.

- *Norwest Corp., et al. v. Commissioner*, 110 T.C. No. 34, 6/29/1998 - Seven of eight internally developed software projects were not considered qualified because the sampled projects involved a "cookbook" approach to development that did not involve technical risk. This case includes a review of the seven tests discussed above.

GROSS RECEIPTS FOR CALIFORNIA PURPOSES:

R&TC §23609(h)(4) defines the term gross receipts for the purpose of computing the California research credit for taxable years beginning on or after January 1, 1993. When computing the fixed-base percentage and average annual gross receipts for California credit purposes, only California gross receipts are used in the computation. California gross receipts should include receipts, minus returns and allowances, from the sale of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser in California. This includes sales to the U.S. government, which are delivered in California. Throwback sales and receipts from services, rents, operating leases and interest are *excluded* from the computation.

MEMBERS OF A CONTROLLED GROUP:

California conforms to the federal rules for assigning this credit among members of a controlled group (IRC §41(f)). To determine the amount of the credit, all members of the same controlled group of corporations are treated as a single taxpayer. (The regulations define controlled group by reference to ownership of more than 50% of the total voting stock (IRC §41(f)(5), IRC §1563(a), Treas. Reg. 1.41-6(a)(3) and 1.52-1(b)-(g)). Nonunitary affiliates may be part of a controlled group.)

First, the total R&D credit of the controlled group is determined and then allocated to the members that had an increase in research expenditures over the base amount. Treas. Reg. 1.41-6(a)(4) provides general examples for allocating the credit. However, for further details regarding how the allocation works refer to Proposed Treas. Reg. 1.41-8 (dated 1/4/2000), which also includes the proper method for allocating the credit. (Note: On 12/27/2000, T.D. 8930 redesignated the aggregation regulation to Treas.Reg. 1.41-6. Prior to that, the aggregation regulation, adopted by T.D. 8251, 5/16/1989, was numbered 1.41-8. This is not to be confused with the proposed aggregation regulation, which happens to also be numbered as Proposed Treas. Reg. 1.41-8.) Treas. Reg. 1.41-6(c) provides rules for members of a controlled group with different accounting periods. Treas. Reg. 1.41-6(d) provides rules for members during the taxable year in more than one group. Treas. Reg. 1.41-6(e) provides rules for intra-group transactions such as in house expenses, contract research expenses, lease payments and payments for supplies.

Note: For tax years beginning on or after January 1, 1990, a different method of allocating the credit to members of a controlled group was used whereby the credit was allocated to the members based on their proportionate share of research expenses. This method, which has been referred to as the "Expenditure Method," was determined to be incorrect. Proposed Regulation §1.41-8 (issued January 4, 2000) clarified the correct method, and referred to it as the "Incremental Method." Under the "Incremental Method" the group research credit is allocated to each member based on the ratio that the member's increase in its qualified research expenses over its base amount bears to the sum of each member's increase in qualified research expenses over the its base amounts.

Taxpayers were allowed to compute the credit using either method for taxable years ending prior to January 4, 2000. For taxable years ending on or after January 4, 2000, the taxpayer must follow the incremental method as prescribed in the proposed federal regulation. According to the proposed regulation, this method can also be imposed in prior years if deemed necessary. * * * * * * * * * * * * * *
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ALTERNATIVE MINIMUM TAX:

The credit cannot be used to reduce AMT. However, for taxable years beginning on or after January 1, 1989, R&TC §23036 was revised to allow the research credit to reduce the regular tax below the tentative minimum tax. If the credit is not used in the current year, it may be carried over to subsequent years until it is exhausted.

TERMINATION DATE:

R&TC §23609 does not provide a termination date for the California research credit. However, be aware that IRC §41 incorporates a termination date, which changes often. Also, note that the federal credit has a lapse period. No federal credit is allowed for expenses incurred between June 30, 1995 and July 1, 1996. This may explain why the federal credit in those years may be smaller than the California credit.

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Reviewed: May 2003

9150 RIDESHARING TAX CREDIT (R&TC §23605)

For years 1989 - 1995 employers may be allowed credits for participating in specific rideshare activities by purchasing and/or leasing vehicles used in an employer sponsored ridesharing program and/or subsidizing public transit passes for their employees.

The credit is allowed instead of any deduction the employer may otherwise claim, such as ordinary and necessary business expenses under IRC §162. Since there is not a comparable federal credit, this may result in a state adjustment. (See MATM 6058)

The credit may not reduce tax below the tentative minimum tax. However, the credit may be carried forward until exhausted.

For rideshare vehicles the credit is equal to 20% (30% if the employer has less than 200 employees) of the purchase cost or 15% (30% if less than 200 employees) of the cost for leasing qualified vehicles. The basis of any ridesharing vehicle must be reduced by the amount of the corresponding credit. If the vehicle is not used for ridesharing or is disposed of within three years, the prorata portion of the unused credit will be added back to the taxpayer’s tax liability. The basis would then be increased by an equal amount included in the tax liability.

The taxpayer is required to maintain a log of the vehicle's use. At the minimum, the log must contain the dates and times driven, the mileage of each trip, and the purpose of each trip. The auditor should review the log to verify that the vehicle was used within the provisions of R&TC §23605. Additionally, the auditor should request the vehicle's owners manual and registration to verify the vehicle's weight and fuel efficiency meets the specified requirements of R&TC §23605.

The credit for subsidizing public transit is equal to the following:

- 10% of the cost if the employer provides free parking,
- 20% of the cost if subsidized parking is provided, or
- 40% of the cost if the employer does not provide free or subsidized parking.

Reviewed: December 2002

9160 SOLAR ENERGY TAX CREDIT (R&TC §23601 - R&TC §23601.5)

Since 1976, California has allowed some type of solar energy credit. The solar energy credit and carryovers have been considerably revised over the years. Specifically, the definitions and requirements of a solar energy system changed dramatically for years 1990 through 1994. Therefore, the auditor should refer to R&TC §23601 through R&TC §23601.5 when examining a solar credit. This section discusses primarily the provisions of the solar energy credit since 1987.

In general, a credit is allowed for a portion of the cost of a solar energy system installed on premises used for commercial purposes. The premises must be located in California and owned by the taxpayer during the taxable year. If a taxpayer leases the solar energy system it may qualify for a credit. For more information on leases refer to the above Bank and Corporation Law sections.

The solar energy credit is allowed to reduce tax below the tentative minimum tax. If the credit is not used in the current year it may be carried forward until the credit is exhausted.

If the credit is material The California Energy Resources Conservation and Development Commission (CEC) should complete the audit and determination of the solar energy system's eligibility. It is current audit policy that the auditor requests an evaluation from the CEC at the start of the audit.

If a material credit exists, the auditor should inform the taxpayer that an examination by the CEC is necessary. To avoid disclosure, the auditor should give the taxpayer a letter, on the program office's letterhead, to forward to the CEC. This letter should contain the following information:

Addressed to:
California Energy Commission
1516 Ninth Street
Sacramento, CA 95814

- A request for a detailed evaluation of the credit
- The taxpayer's name.
- The taxable years questioned.
- The amount of the credit claimed.

The auditor should instruct the taxpayer to forward the letter to the CEC. The taxpayer is responsible for resolving the issue with the CEC and for forwarding the CECs final determination to the auditor.

There are a few areas that the auditor can review without CEC involvement. Listed below are the most common audit areas:

There is no provision in the statute for a credit for solar energy systems installed during 1989.

The solar energy system must be installed in California.

The cost of the solar energy system must be reduced by any grants provided by any public entity for the system.

The allowable percentage for computing the credit has changed from year to year.

- 1987 is 12%
- 1988 is 10%
- 1989 has no provision for a credit
- 1990 - 1994 is 10%

The basis of the solar energy system must be reduced by the amount of the credit allowed and any public grants received.

The required useful life of a solar energy system has changed throughout the years. Information on this area can be found in the depreciation schedules. The useful life requirement is as follows:

- 1987 - 1988 useful life is three years or more
- 1989 has no provision for a solar energy credit
- 1990 - 1994 useful life is five years or more

For systems installed in 1990 and after, each owner's share of the credit is computed in proportion to its ownership interest in the premise. In the case of a partnership, the credit may be divided per a written partnership agreement. (The partnership provision applies to 1987 and 1988 as well.)

Reviewed: December 2002